Supreme Court, U.S.
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No. 02-1291

IN THE

Supreme Court of the United States

TAX AND ACCOUNTING SOFTWARE CORPORATION, TIM E. KLOEHR, and SHERYL KLOEHR,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF

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STATEMENT PURSUANT TO RULE 29.6

The Corporate Disclosure Statement for petitioner, Tax and Accounting Software Corporation, was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that Statement.

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The Petitioner requests this Court to review the decision of the Tenth Circuit court of appeals in order to resolve a conflict between the circuits regarding the criteria to be used in determining eligibility for the research tax credit provided by Section 41(d) of the Internal Revenue Code, and to settle uncertainty as to that criteria.

I. The Circuits Have Expressly Stated a Conflict in the Research Credit Criteria

The IRS begins its argument in opposition to the Petition for Writ of Certiorari of Tax and Accounting Software Corporation ("TAASC") by asserting that there is no conflict between the Tenth Circuit, that decided the TAASC case, and the Seventh Circuit, that decided the appeal in *Eustace v. Commissioner*, 312 F.3d 905 (7th Cir. 2002). The IRS clearly misreads those cases. The Tenth Circuit expressly rejected the criteria established in the Seventh Circuit calling for the taxpayer to expand and refine the principles of computer science in order to qualify for the credit. Instead, the Tenth Circuit found only that the information discovered be "new," a much lower standard. On the other hand, the Tenth Circuit imposed a requirement that the information discovered be separate from the product being developed, a requirement never imposed by the Seventh Circuit or any other court addressing the tax credit and not contained in the statute, the legislative history of the statute, or any regulations. These conflicting criteria can only be resolved by this Court, and it must do so in order to assure that the credit will available to taxpayers on a consistent basis.

II. The Proposed Regulations Should Determine the Issues Before the Court

The IRS asserts that the Court should disregard the regulations it proposed on December 26, 2001, because those regulations have not been finally adopted and are, therefore, subject to modification or further consideration by the agency. Resp. 6. Those proposed regulations, however, are in effect now and apply to work being currently conducted and to all open returns. 66 Fed. Reg. at 66,367 ("Notwithstanding this prospective effective date, Treasury and the IRS believe that these rules prescribe the proper treatment of the expenditures they address, and the IRS generally will not challenge return positions consistent with the proposed regulations. Therefore, taxpayers may rely on these proposed regulations until the date final regulations under § 1.41-4 are published in the Federal Register.") The proposed regulations have, therefore, already displaced the "final" regulations that were issued in January 2001. Because those "final" regulations were not in effect at the time the work at issue here was performed, and do not apply to open returns, they have absolutely no bearing on the issues before the court, even if they do reflect the "exceed, expand and refine the principles of computer science" criteria adopted by the Seventh Circuit, but not the Tenth Circuit.

Moreover, the proposed regulations serve to demonstrate the long, arduous road that the IRS and taxpayers have traveled since the research credit was established in 1981. Over 20 years later, although there still are no "final" regulations, there is at least some consensus on the intent of the statute. Although the IRS is unwilling to concede that the consensus is applicable here, it offers no rational reason why the consensus should not apply to this taxpayer. Indeed,

it is perhaps because this taxpayer has expended funds to fight this battle that the IRS has finally acted after all these years.[1]

A. The Discovery Test

The IRS criticizes the district court opinion, and urges this Court to affirm the opinion of the Tenth Circuit based on the different conclusions reached by those courts with respect to the discovery test requirements included in the criteria for eligibility for the tax credit. The district court found that taxpayers need only discover information that was technical in nature to satisfy the discovery test[2], while the court of appeals determined that the information discovered must be not only technical in nature, but also new information which expands existing knowledge.

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1. As the Seventh Circuit noted in *Eustace*,

> Section 41's predecessor was enacted in 1981, and § 41 has been on the books in its current form since 1986, but the IRS has yet to promulgate the regulations that are important to this statutory design. (Section 41 refers ten times to regulations that the Secretary of the Treasury is to develop and issue.)

312 F.3d at 908. It is clear the taxpayer would get the credit if the IRS had acted, say, ten years ago; what policy justification is there for denying the taxpayer the credit simply because the IRS sat on its hands for such a long period of time?

2. The IRS characterizes the discovery test requirements reflected in the district court opinion and the proposed regulations as more "lenient." Resp. 6. TAASC characterizes those requirements as a more accurate reflection of the legislative history of the statute.

The proposed regulations, which apply to all open returns, including the returns at issue here, reflect the opinion of the district court, not the court of appeals.

TAASC does not now contend, nor did it ever, that any deduction for research taken under Section 174 automatically satisfies the credit requirements of Section 41(d). TAASC agrees with the IRS that three additional tests must be satisfied: 1) the information discovered must be technological in nature; 2) the information must be intended to be used in the development of a new or improved business component of the taxpayer; and 3) substantially all the research activities must constitute a process of experimentation. TAASC only asserts, as it has from the beginning, that so long as the information is technological in nature, Section 41(d) imposes no higher "discovery" requirement than does Section 174. Except for its position in this and the other case pending before this Court, the IRS agrees with that interpretation. 66 Fed. Reg. at 66,363 ("Treasury and the IRS believe that the requirement that qualified research be "undertaken for the purpose of discovering information which is technological in nature" is intended to distinguish technological research, which may qualify for the research credit, from non-technological research, which does not.") This interpretation, which the IRS now endorses, conforms with settled principles that statutes are not to be read in a manner that fails to give separate meaning to each of their provisions.

B. The Process of Experimentation Test

The IRS asserts that the Tenth Circuit correctly decided that the work conducted by TAASC did not satisfy the process of experimentation test. That decision, however, clearly does

not reflect the legislative history of the credit or the proposed regulations.

The Tenth Circuit court stated initially:

> We conclude that the term "process of experimentation" can include research in which the taxpayer tries alternative methods to achieve a result and all of the methods are already commonly known, but it is uncertain which method will allow the taxpayer to achieve the result.

Pet. App. 20a. It is undisputed that the work accomplished by TAASC satisfies this criteria. The Tenth Circuit, however, went on to determine, based on its reading of *United Stationers v. United States*, 163 F.3d 440, 446 (7th Cir. 1998), that the research must involve technical uncertainty about the possibility of developing the product. Pet. App. 22a.

The Tenth Circuit's reliance on *United Stationers* was misplaced. The *United Stationers* court addressed the development of internal use software, a process which, pursuant to statute, must meet a much higher standard than the development of commercial software. Section 41(d)(4)(E). That standard includes the requirement that the taxpayer assume some risk that the development of the product or business component is technically feasible. That risk component does not apply to the work performed by TAASC. Thus, although TAASC may have been confident that the products it envisioned were technically feasible, there remained throughout the uncertainty of how those products would be designed. This is all that Congress required.

TAASC, and the district court, point to, among other things, the language of the legislative history of reenactments of the credit to confirm their interpretation of the process of experimentation test. The IRS criticizes this reference as reliance on "post-enactment pronouncements by a later Congress as to what an earlier Congress intended." The IRS, however, relied on exactly the same reenactment history when promulgating the proposed regulations which apply to all open returns. 66 Fed. Reg. at 66,365 (citing the legislative history to the 1986 Act, the Tax and Trade Relief Extension Act of 1998, Public Law 105-277, 112 Stat. 2681-888 (the 1998 Act), and the Tax Relief Extension Act off 1999, Public Law 106-170, 113 Stat. 1860, 1919.)

Contrary to the assertions of the IRS, TAASC does not now, nor did it ever, contend that "debugging programs" alone constituted a process of experimentation that qualified for the tax credit. Debugging is but one of the many tasks associated with the production of new or significantly improved software products. *Computer Associates International, Inc. v. Altai, Inc.*, 982 F.2d 693 (2d Cir. 1992).

The IRS contention that the proposed regulations, which apply to TAASC's open returns, do not support TAASC's claim, is without basis. Those regulations provide that a taxpayer's work will *not* qualify for the credit if there is *no* uncertainty as to:

> the capability of achieving the development of the product
>
> *and*

> the method of achieving the development of the product
>
> *and*
>
> the appropriate design of the product

66 Fed. Reg. at 66,368.

If all three of these components of development are certain, no process of experimentation has been conducted.

In this case, although there may not have been uncertainty as the capability of achieving the development of the products at issue, the facts are undisputed that there was significant uncertainty as to the method of achieving that development of the product and the appropriate design of the product. Although the alternative design tools explored by TAASC may have been known, it is undisputed that no one knew which of those alternatives would be applicable to achieve the design of the products under development. It is that uncertainty which led TAASC to conduct a process of experimentation. The work accomplished by TAASC, therefore, satisfies the intent of congress as reflected in the original legislative history, as well as the history of subsequent enactments of the statute, and satisfies the requirements of the proposed regulations.

III. Public Policy Will Not Support The Standards Urged By The IRS.

The public policy arguments asserted by TAASC in its Petition are both valid and relevant, and reflect the congressional intent giving rise to the tax credit at issue here.

Moreover, the IRS has concurred that the policy asserted by TAASC is accurate. 66 Fed. Reg. at 66,363 ("Treasury and the IRS have determined that the definition of qualified research set out in [the previously issued "final" regulations] does not fully address Congress' concerns regarding the importance of research activities to the U.S. economy.") That policy demands that the criteria urged by the IRS in this case be abandoned in favor of the criteria contained in the proposed regulations.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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